SECRET

EXTENSION OF DECEMBER 29, 1981 SANCTIONS ON OIL AND GAS EQUIPMENT TO THE U.S.S.R. AND IMPACT ON POLITICAL AND TRADE RELATIONS WITH EUROPE

ISSUE

The President's decision to extend the December 29 sanctions to include equipment produced by subsidiaries of U.S. companies abroad as well as equipment produced abroad under licenses issued by U.S. companies, has resulted in serious strains in political and trade relations between the U.S. and several EC members, notably France, Germany, the U.K. and Italy. Japan's reaction to the decision is considerably less critical due to the production phase of the Sakhalin project having already been postponed, together with assurances given by the Soviets that the 1975 General Agreement governing the project would remain in force.

BACKGROUND

On June 18, 1982, President Reagan announced his decision to extend foreign policy controls on exports of oil and gas equipment and technical data to the U.S.S.R. to include products manufactured abroad by U.S.-owned or controlled companies or by foreign firms under U.S. licenses. Pre-June 18, 1982 controls restricted exports and re-exports of U.S. origin and gas goods and technical data for all phases of the U.S.S.R. oil and gas industry (exploration, production, transmission and refining). The controls on transmission and refining equipment were imposed on December 30, 1981, as a result of Soviet-sponsored repression in Poland. Controls on exploration and production were first imposed in July 1978 in response to harsh treatment of Soviet dissidents and the arrest of an American businessman. In addition, all licensing of high technology items to the U.S.S.R. was suspended by the December 30, 1981 decision.

The actions of June 18 were necessary because of serious U.S. concern over the continued lack of reconcilation in Poland, and continued U.S. opposition to the Trans-Siberian natural gas pipeline. In the past six months there has been little moderation of the repression in Poland.

The President's decision to amend oil and gas controls will increase the cost of the pipeline, and delay its construction. Assuming our friends and allies do not transgress our regulations, the Soviets are faced with several options: use smaller turbines from Switzerland and other sources, employ electric motors instead of gas turbines to power the compressors, or produce their own gas turbines. All of the options will significantly delay pipeline construction, raise the costs to the Soviets, and affect the efficiency and reliability of the pipeline.

European Reactions. As anticipated, our European and Japanese allies have reacted sharply to the expanded sanctions. Their reactions, thus far, have been rhetorical, however. They have not taken any concrete measures, e.g., court action or blocking legislation.

The FRG has voiced criticism, using ~~statements~~ like "economic cold war", claiming that the U.S. decision went contrary to understandings reached during President Regan's visit to Bonn and to agreements made at Versailles. The French followed with equally hostile accusations and expressed fear for the weakening of the Western Alliance. Italian officials have also expressed concern over the expansion of the sanctions, claiming that the U.S. action would hurt Western European companies more than the U.S.S.R. The European Community issued a statement, following a late June summit meeting, criticizing the expansion of the sanctions. The EC claimed that the U.S. action, taken without consultation with the Community, is contrary to principles of international law, unacceptable to the Community, and unlikely to be recognized in EC courts. (This criticism is somewhat unwarranted since consultations have been ongoing since the imposition of sanctions in December 1981.) The Community also called for a dialogue at the highest levels to find solutions to a range of contentious trade issues ranging from steel to agriculture.

The U.K. has issued an order invoking the Protection of Trading Interests Act (PTI) of 1980, asserting that the U.S. controls are damaging to British trading interests. The order, thus far, does not carry substantive actions. The British can take additional measures to: (1) require U.K. firms not to provide information to the USG or (2) prohibit them from complying with U.S. regulations. British officials stressed that the U.K. wants to avert confrontation with the U.S. on this issue. Other countries might follow the precedent in an export controls conflict fifteen years ago when a French court put a receiver in charge of a U.S. subsidary to compel shipments to China barred by U.S. controls.

(A State Department paper, "Poland and Economic Sanctions: Managing These Issues with the Allies, Poles, Soviets, and Domestically," which discusses this issue, among others, at greater length is attached. Also attached is a paper, "Energy Alternatives," which discusses the U.S. effort, currently under the guidance of an interagency group headed by Under Secretary Buckley, to develop other energy sources in the West as alternatives to gas from the Siberian pipeline.)

Economic Costs. The President's decision to expand controls on oil and gas equipment and technology can result in a noticeable economic loss to U.S. firms and U.S. foreign subsidiaries and licensees. It is estimated that U.S.-based company export losses from the December 30 sanctions could range from $300 - $600 million over the next three years. U.S.-owned or controlled companies abroad could lose, as a result of the June 18 decision to extend controls, an additional $600 million over the next three years, while foreign firms which are licensees of U.S. technology stand to lose over $1 billion over the next three years.

Besides the estimated short-term costs to U.S. companies and their foreign subsidiaries there can be a diminution of the U.S. reputation as a reliable supplier of equipment and technology and as a dependable commercial partner.

There exist about 40 U.S. companies with subsidiaries that have been brought under the export control umbrella as a result of the June 18 actions. The major ones are (country in parenthesis indicates where subsidiary is located): ARMCO (Brazil), Baker (U.K.), Camco (U.K.), Cameron Iron Works (France), Control Data (France), Dresser (Canada, France), FMC (France), Grove Valve and Regulator (Italy), Honeywell Control and Measuring Devices (Austria), Howmet Turbine Components (U.K., France), and Rockwell International (Netherlands).

In addition there exist at least an equal number of foreign firms that depend on U.S. technology to manufacture oil and gas equipment. The significant ones include: Alsthom-Atlantique (France, GE licensee), John Brown (U.K., GE licensee), AEG Kanis (FRG, GE licensee), Nuovo Pignone (Italy, GE licensee), Mitsubishi (Japan, TRW licensee), and Hitachi (Japan, GE licensee).

Legal Implications. To date, we know of no violations of the U.S. controls. Any creditable investigative leads concerning questioned controls would, of course, be vigorously investigated by the Commerce Department Office of Export Enforcement. If, as a result of such an investigation, a violation were found to have occurred, appropriate administrative and/or criminal sanctions would be pursued, depending on the circumstances underlying the violation(s), i.e., the technology and products involved, the scope and nature of the facts constituting the alleged violation(s), the strength and availability of competent evidence of the alleged offense, and the equity considerations in the case. We have a broad range of administrative and criminal sanctions available against any violations:

Administrative Sanctions -- Formal administrative proceedings can be initiated which could result in: (1) the imposition of a civil penalty of up to $10,000 per violation for violations of the foreign policy controls; (2) suspension or revocation of existing export licenses; and/or (3) partial or total denial of U.S. export privileges for a specified period of time.

Criminal Sanctions -- Criminal charges would also be considered for violations of the controls. Any foreign company official individually charged may be arrested if he enters the United States. He may also be arrested on the basis of probable cause. Anyone who knowingly violates any of the controls is subject to a fine of five times the value of the exports or $50,000, whichever is greater, or to a five year prison term, or both. Willful violations of the new controls on the part of a company could result in the firm's being fined five times the value of the export involved or one million dollars, whichever is greater. Individuals who willfully violate the controls may be fined up to $250,000 or sentenced to a prison term of up to ten years, or both for each violation.

 SECRET

Poland and Economic Sanctions: Managing These Issues with the Allies, Poles, Soviets and Domestically

BACKGROUND

The combination of mounting Allied resentment over the President's June 18 sanctions decision, hints that significant moves by the Polish regime toward relaxing martial law may be announced July 22, and a delicate negotiation between the Pope and the Polish regime regarding his proposed visit to Poland in August make it essential that we focus on the sanctions issue. How we manage this issue over the next month will have very broad implications, since we have linked other questions, such as this fall's CSCE meeting in Madrid and sanctions on oil and gas equipment, to developments in Poland. The manner in which we handle the increasingly pressing question of Polish debt will also have ramifications far beyond Poland itself given the manifold uncertainties currently at play on the international financial markets.

Impact of the Sanctions Decision. How our European friends plan to play this issue remains a matter of conjecture. To a degree, the decision rests with the Soviets, who can decide whether or not to insist that the contracts, which cannot now be fulfilled under US regulations, be met by the three European turbine manufacturers. The Soviets could, by calling the Europeans for non-performances, cancelling the contracts, and invoking penalty clauses, remove a certain element of urgency from our consideration of the issue, although the resulting bankruptcies and additional unemployment in Western Europe would further sour Atlantic relations for some time to come. This could also be the source of legal challenges to the President's decision both here and in Europe. Given the uncertainties involved, the legal route does not offer an attractive means to resolve this dispute from our point of view. For our Allies, this route appears much too time-consuming as far as the case at hand is concerned.

Unless the Soviets move quickly to invoke penalty clauses and/or cancel their contracts, we estimate that the Europeans will make yet another effort, individually at first and perhaps then collectively, to persuade the President to reverse his decision. If they follow this course of action, we will have a certain element of leverage over them. The question which then arises is what we should seek to persuade them to do, the two obvious alternatives being further steps regarding credits and actions in the Polish context.

SECRET

Possible Linkage with Credits. One reason for European unhappiness with the June 18 decision is their claim, which can only be based on a misreading of the situation, that the understanding reached at Versailles on future credits to the Soviet Union presupposed a decision by the President to permit the execution of contracts in existence at the time of his original December 30 sanctions decision. The President's reaction to the agreement reached at Versailles makes clear that lacking a strong credits arrangement he felt he should extend the sanctions and link the extension to continuation of the situation in Poland. Obviously, further Allied action to restrict official credits and credit guarantees to the Soviet Union is a highly desirable objective. We must recognize, however, that there is very little possibility with a continuation of the sanctions that the Allies, in particular the French, will go beyond (a) the very limited agreement at Versailles (or even effectively implement it) or (b) the June 30 agreement to revise the OECD export credit consensus arrangement, which has the effect of pushing the minimum lending rate for credits to the Soviet Union up from 10.5 percent to 12.15 percent. We should further recognize that even were the Allies willing to do significantly more on the credits front, it is not clear that this would satisfy the President's requirements, which are explicitly tied to Poland; to mislead them on this score would be irresponsible. This leads us back to the situation in Poland and the inescapable fact that, at least in the short run, absent an extremely umpromising effort to put together a credits-for-sanctions package, movement on the sanctions depends on developments in Poland.

Situation in Poland. At this point, the outlook for movement in Poland toward satisfying the three Allied conditions (end of martial law, release of detainees and resumption of "genuine" dialogue with Solidarity) is uncertain at best. Clearly, a major struggle is underway within the Polish leadership regarding what measures, if any, should be taken in connection with the July 22 National Day toward satisfying these conditions. From the beginning, US and Alliance policy has been that sanctions are reversible provided the conditions are met. One thing which is almost certain, however, is that whatever emerges on July 22 will be less than full satisfaction of the three conditions, posing in a particularly difficult way the question which we have not yet been unable to answer of "how much is enough" to remove some, or all, of the sanctions. The Pope's proposed visit to Poland in connection with the 600th Anniversary of the Madonna of Czestochowa is another factor putting pressure on the Polish leadership to relax martial law and its attendant restrictions. Opposition to the Papal visit, notably from

Moscow, dramatizes the link between this event and the internal situation in Poland.

Allied Attitudes. Our Allies are anxiously awaiting any move by the Polish authorities which can serve as a basis for relaxing, and if possible removing, both the political and economic sanctions which they adopted following the December 13 imposition of martial law. The Allies are not united on which sanctions to relax or on the degree of urgency; they expect a sober and restrained approach and hard bargining with us. Nonetheless, the urge to relax sanctions if the Polish authorities move is general. On the political side this relates primarily to how the West will handle the resumption of the Madrid CSCE Review Conference on November 9 and the possibility of enhanced contacts with the Warsaw regime. None of the Europeans belive the resumed conference can or should be devoted exclusively to Poland, as the last session was, and the search is on for ways to open out the agenda; the Swiss are peddling the concept of private US-Soviet contacts to turn the key. On high-level contacts with the Polish government, these have been sporadic since December 13 (Schmidt, for example, met with Foreign Minister Czyrek June 14 in New York). Our Allies see some benefit in an enchanced political dialogue with Warsaw.

On the economic front, the Allies are clearly anxious to remove some or all of their remaining sanctions, particularly in the critically important area of debt rescheduling and new credits. Although there is little or no enthusiasm in Western Europe for assistance to Poland, per se, aside from an impressive humanitarian effort centering in Germany, there is substantial support for debt rescheduling and perhaps the provision in that context of limited new assistance to Poland (particularly for spare parts and industrial raw materials needed for exports), which would, in turn, make it possible for the Poles to service, even in a symbolic way, their rescheduled debts. The Europeans are distinctly unenthusiastic, given the mounting pressures on the international financial markets, about encountering the uncertainties which default on Poland's $27 billion foreign debt would entail. Even the most exposed European banks (Dresdner, BFGW and Credit Anstalt-Bankverein) could absorb a Polish default, but the Europeans fear the ripple effect of a default, not without reason. Unless the Europeans decide to go it alone, any movement on rescheduling would depend upon whether the US is willing.

Taking all these factors, including the European attitude, into account, our key objectives will be to: (a) join with our Allies in exerting maximum pressure on the Poles, and the Soviets, prior to July 22 to satisfy the three conditions; and (b) avoid a situation in which we and our Allies argue about whether moves taken by the Poles to relax the December 13 measures are "enough" to justify corresponding moves by the West and, if so, which measures would be appropriate on our side. Reaching agreement on this point will be extremely difficult, and the Poles (and Soviets) will doubtless do everything they can to use this issue to provoke additional disputes in the West.

ENERGY ALTERNATIVES

ISSUE

The United States has been and continues to be actively engaged in developing the abundant and economically attractive energy resources in the West as an alternative to increased imports of Soviet energy by Western Europe.

BACKGROUND

There are abundant and economically attractive energy resources within the Western community. The United States is striving for a new commitment with our European and Japanese economic partners to develop indigenous energy resources through greater reliance on market forces supplemented by government action when broader Western economic and security concerns are threatened.

Under Secretary Buckley has convened a high level inter-agency group to review these energy resources as alternatives to the Siberian pipeline and to determine what actions the United States can take to assist in their development. Ambassador Galbraith has been consulting with North Sea petroleum producers and European governments to determine what measures would be necessary to accelerate development of North Sea oil and gas that could minimize Western European dependence on Soviet energy. Some progress has been made. The Norwegian press has noted the energy security significance of North Sea petroleum for Western Europe. The Netherlands and Belgium have virtually withdrawn from the Siberian project, in favor of using more Dutch natural gas. New attention has been focussed on the regulatory and tax obstacles to North Sea hydrocarbon development. A U.S. mission has attracted new interest in U.S. energy exports to Western Europe.

While the promotion of alternatives to the Siberian pipeline is still an early stage, it is already receiving public attention in Western Europe and has resulted in the beginning of quiet discussions on the Continent.